

## MSP #23

## Early Intervention, Offers in Compromise, and Proactive Outreach Can Help Victims of Failed Payroll Service Providers and Increase Employment Tax Compliance

### RESPONSIBLE OFFICIAL

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### DEFINITION OF PROBLEM

Payroll service providers (PSPs) play an important role in tax compliance by helping employers navigate and follow increasingly complex employment tax laws, and freeing them to focus on their core business purposes.<sup>1</sup> When a PSP goes out of business or misappropriates its clients' funds, the employers remain liable for the unpaid payroll taxes. Each PSP failure can result in grave financial harm to multiple clients that may be required to pay the amount of payroll taxes twice, once to the PSPs and again to the IRS, along with interest and penalties.<sup>2</sup> Some small businesses may be unable to recover from these setbacks and may be forced to cease operations and lay off their employees.

Despite a number of PSP failures over the last five years, leaving thousands of employers with hundreds of millions of dollars in unpaid employment taxes, the IRS has not publicized its Effective Tax Administration (ETA) offer in compromise (OIC) authority as a viable collection alternative and has consistently underutilized offers to provide relief to victims.<sup>3</sup> The number of accepted non-economic hardship (NEH) ETA OICs ranged between 21 and 45 during each of the past five years, with only 28 offers accepted during the last full fiscal year (FY) 2012.<sup>4</sup>

For nearly a decade, the National Taxpayer Advocate has voiced concerns about the compliance problems and significant financial burden on taxpayers associated with PSP and other third-party payer failures.<sup>5</sup> Although we commend the IRS for making significant progress

<sup>1</sup> IRS data show that paid preparers submitted 34.6 percent of Forms 940, 941, 943, and 944 returns in the last full tax year 2011. However, the number is likely substantially higher. IRS, Compliance Data Warehouse (CDW), Business Return Tax File Table (Oct. 2012).

<sup>2</sup> See, e.g., Internal Revenue Code (IRC) §§ 6656(a) and 6672(a).

<sup>3</sup> Between FY 2007 and FY 2012 (to date), as a result of the IRS's recommendations, the Department of Justice (DOJ) criminally prosecuted at least 24 owners and operators of different types of third-party payers who collected about \$300 million in employment taxes from their client employers and did not pay them over to the Treasury. IRS, Employment Tax Fraud, Case Examples, FY 2007–FY 2012. One payroll company's executives embezzled about \$1.3 million from about 3,000 clients across the country. The Morning Call, *Two Easton-area Men Stole Nearly \$1.3 million from New Jersey Payroll Company* (Oct. 24, 2011). Another payroll company's bankruptcy left about 1,500 clients with unpaid employment taxes. The Washington Post, *The Culprit Could Be Dead, But Local Tax Case Lives On* (Oct. 13, 2008).

<sup>4</sup> IRS responses to TAS information requests (June 29, 2012 and Oct. 22, 2012).

<sup>5</sup> See e.g., Hearing Before the H. Comm. on Small Business, 112th Cong., 1st Sess. (Apr. 13, 2011) (statement of Nina E. Olson, National Taxpayer Advocate); National Taxpayer Advocate 2007 Annual Report to Congress 337-354 (Most Serious Problem: *Third Party Payers*).

in addressing the issues identified in previous Annual Reports to Congress, serious problems persist, including:

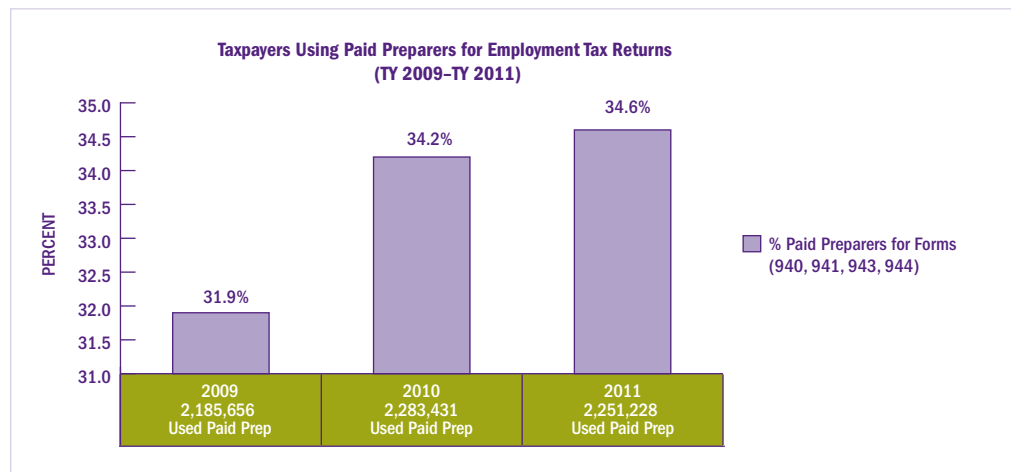
- The absence of early detection and timely intervention in PSP delinquencies that compound problems for victims of PSP failures;
- Ambiguous policies and procedures that limit the use of ETA OICs as a viable collection alternative for victims of PSP failures; and
- Ineffective communications and outreach to taxpayers about the risks inherent in outsourcing payroll tax obligations and steps they can take to mitigate those risks.

## ANALYSIS OF PROBLEM

### Background

The complexity of employment tax compliance poses a financial and administrative burden for small business owners leading many to outsource their payroll to third parties.<sup>6</sup> One study indicates that in 2012, about 85 percent of small businesses sampled paid an external tax practitioner or accountant to handle their tax responsibilities, while about 41 percent hired a PSP to prepare and pay their payroll taxes.<sup>7</sup> IRS data show that a growing number of taxpayers used paid preparers for employment tax returns in tax years (TYs) 2009-2011, as depicted in Figure 1.23.1 below.

**FIGURE 1.23.1. Taxpayers' Usage of Paid Preparers for Employment Tax Returns in TYs 2009-2011<sup>8</sup>**



<sup>6</sup> For a detailed description of third-party payer arrangements, see National Taxpayer Advocate 2007 Annual Report to Congress 339 (Table 1.22.1, *Third Party Arrangements*). See also IRS, Publication 4019, *Third Party Authorizations, and Levels of Authority* (May 2012), the original version of which the IRS developed in collaboration with TAS.

<sup>7</sup> National Small Business Association, *2012 Small Business Taxation Survey* (Apr. 2012). PSPs that are members of the National Payroll Reporting Consortium (NPRC) represent over 1.4 million employers with over 35 million employees, exceeding one-third of the private-sector workforce. See <http://www.nprc-inc.org/about.html> (last visited Oct. 20, 2011).

<sup>8</sup> IRS, CDW, Business Return Tax File Table (Oct. 2012). We considered a taxpayer to be using a paid preparer if a paid preparer completed at least one quarterly or annual return for the taxpayer. PSPs that are members of the NPRC represent over 1.4 million employers with over 35 million employees, exceeding one-third of the private-sector workforce. See <http://www.nprc-inc.org/about.html> (last visited Oct. 20, 2011).

## Early Intervention, Offers in Compromise, and Proactive Outreach Can Help Victims of Failed Payroll Service Providers and Increase Employment Tax Compliance

In the more than 65 years since the enactment of the IRC Subtitle C, *Employment Taxes*, the payroll industry has originated various types of third-party payer (TPP) arrangements for reporting, filing, and paying employment taxes, which include PSPs, aggregate filers (Form 2678 Agents),<sup>9</sup> reporting agents (RAs) (Form 8655 Agents),<sup>10</sup> and Professional Employer Organizations (PEOs).<sup>11</sup> This discussion is limited to PSPs.

A PSP is a third party paid by an employer to administer the employer's payroll and employment tax responsibilities, including one or more of the following:

- Prepare paychecks for employees;
- Prepare employment tax returns using the employer's Employer Identification Number (EIN);<sup>12</sup>
- File employment tax returns for the employer, which are signed by the employer;
- Make federal tax deposits (FTDs) and federal tax payments (FTP) and submit this information for the taxes reported on the employment tax returns; and
- Prepare Form(s) W-3 and Form(s) W-2 for the employees using the employer's EIN.<sup>13</sup>

An employer's use of a PSP does not relieve the employer of its employment tax obligations or liability.<sup>14</sup> Unlike some other TPPs, PSPs are not liable for an employer's portion of employment taxes either as employer or agent.<sup>15</sup> Employment tax non-compliance by a PSP may result in delinquent client accounts.<sup>16</sup> While most PSPs are legitimate and trustworthy companies, a few "bad actors" have defrauded their clients and tarnished the image of the

<sup>9</sup> These agents are also commonly referred to as "IRC § 3504 agents" that can file employment tax returns of their clients under their own EIN. IRC § 3504 agents report, deposit, and pay the employment taxes of their clients under the agent's EIN. Both the § 3504 agent and the employer are liable for the employer's employment taxes while the agent authorization is in effect. See IRC § 3504; Rev. Proc. 70-6, 1970-1 C.B. 420; Form 2678, *Employer/Payer Appointment of Agent*.

<sup>10</sup> See Rev. Proc. 2012-32, 2012-34 I.R.B. 267. Reporting agents report and deposit employment taxes on behalf of their clients. A reporting agent assumes no liability for the clients' employment tax withholding, reporting, payment, or filing duties. IRS, *Third Party Arrangements*, available at <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Third-Party-Arrangements> (last visited Oct. 30, 2012).

<sup>11</sup> A PEO, sometimes referred to as employee leasing company, enters into an agreement with a client to provide employees to perform services for the client, pay compensation to the employees, and assume responsibility to collect, report, and pay employment taxes under the EIN of the PEO. A PEO may represent to a client that the PEO is the employer of the workers providing services to the client. IRM 5.1.24.6 (Aug. 15, 2012). See also IRM 5.1.24-1 (Aug. 15, 2012); IRS, *Third Party Arrangements*, available at <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Third-Party-Arrangements> (last visited on Sept. 9, 2012).

<sup>12</sup> Employment tax returns generally include Form 94X series.

<sup>13</sup> IRM 5.1.24.4.2 (Aug. 15, 2012).

<sup>14</sup> Employers that pay wages for services of an employee are generally required to deduct and withhold Social Security, Medicare, and income taxes from the wages. See generally IRC §§ 3102(a), 3121(a), and 3402(a).

<sup>15</sup> Employers are also responsible for unemployment tax (FUTA) and their share of the Social Security and Medicare tax for their employees. See generally IRC §§ 3301, 3111(a) and (b), 3306(b).

<sup>16</sup> See, e.g., IRM 5.1.24.5.1(2) (Aug. 15, 2012).

industry.<sup>17</sup> Between FY 2007 and FY 2012, as a result of the IRS's recommendations, the DOJ criminally prosecuted at least 24 owners and operators of different types of third-party payers who collected about \$300 million in employment taxes from thousands of client employers and did not pay them over to the Treasury.<sup>18</sup>

### The IRS has Made Significant Progress in Addressing Third-Party Payer Failures.

The National Taxpayer Advocate commends the IRS for actions taken in collaboration with TAS during past five years, which include:<sup>19</sup>

- The Small Business Self Employed (SB/SE) division's study of the TPP program;<sup>20</sup>
- The new IRM section describing TPP arrangements for employment taxes, and providing collection approaches to employers that are victims of TPP misappropriation, including penalty abatement and collection alternatives;
- Modification of the Reasonable Cause Assistant (RCA) to allow abatement of penalties if the taxpayer can prove timely and full payment of employment taxes to the TPP;<sup>21</sup>
- Designation of PSP/PEO Coordinators in each Collection Area to act as liaisons for the coordination of PSP and other third-party payer issues;<sup>22</sup>
- Development of training for revenue officers on recognizing and working cases involving TPPs;<sup>23</sup> and
- Issuance of guidance for assessment of the Trust Fund Recovery Penalty (TFRP) against third-party payers, including responsible parties within a PSP or a PEO.<sup>24</sup>

Despite these efforts, serious problems remain.

<sup>17</sup> For example, during the first quarter of 2011, one payroll service provider in Pennsylvania filed for bankruptcy after failing to deposit \$4.1 million on behalf of its 300 clients. SB/SE Research Study: *EFTPS Program, Requirements Change Notice for EFTPS – Final Report, Executive Summary and Recommendations* (Apr. 24, 2012). Other payroll company executives embezzled about \$1.3 million from about 3,000 clients across the country. *The Morning Call, Two Easton-area men stole nearly \$1.3 million from New Jersey payroll company* (Oct. 24, 2011). See also U.S. Dept. of Justice Press Release, *Payroll Service Provider Indicted for Tax Evasion, Failing to Pay Employment Taxes* (July 19, 2012) (discussing Siham Solutions, Inc., a payroll service company, which had numerous clients, including home health care providers).

<sup>18</sup> IRS, *Employment Tax Fraud, Case Examples, FY 2010 – FY 2012*, available at <http://www.irs.gov> (last visited Sept. 11, 2012). See also National Taxpayer Advocate 2009 Annual Report to Congress 270-271.

<sup>19</sup> Acting upon recommendations in the 2007 Annual Report to Congress, the IRS established a joint task force with TAS to work on third-party payer failures in spring 2008. See National Taxpayer Advocate 2007 Annual Report to Congress 337-354 (Most Serious Problem: *Third Party Payers*).

<sup>20</sup> SB/SE Study, *Program Review of Third Party Payers* (undated); IRS response to TAS information request (Aug. 26, 2012).

<sup>21</sup> IRM 5.1.24.5.5.1 (Aug. 15, 2012).

<sup>22</sup> IRM 5.1.24.5.1 (Aug. 15, 2012).

<sup>23</sup> SB/SE CPE Training Module (FY 2012), *Third Party Payer Arrangements for Employment Taxes*; IRS response to TAS information request (Aug. 26, 2012).

<sup>24</sup> See IRM 5.7.3.3.3 (July 19, 2012); SB/SE, *Interim Guidance for Conducting Trust Fund Recovery Penalty Investigations in Cases Involving a Third-Party Payer*, SBSE-05-0711-044 (July 1, 2011). This guidance is consistent with a 2004 legislative recommendation by the National Taxpayer Advocate. National Taxpayer Advocate 2004 Annual Report to Congress 394-399. Individuals who have willfully failed to pay the trust fund portion of delinquent employment taxes may be subject to the TFRP. IRC § 6672. Trust fund taxes are the income tax, Social Security, and Medicare taxes employers withhold from their employees' wages.

Early Intervention, Offers in Compromise, and Proactive Outreach Can Help Victims of Failed Payroll Service Providers and Increase Employment Tax Compliance

### **Early Detection of PSP Noncompliance and Timely Intervention Can Improve Compliance and Alleviate Financial Burden on Victims of PSP Failures.**

Early intervention is key to protecting affected employers from PSP failures and preventing the accumulation of substantial employment tax liabilities, as well as minimizing revenue loss to the federal government. Early intervention includes education and outreach, and is aimed at “touching” the taxpayer as soon as possible after the IRS detects a delinquency. While the IRS has an interest in collecting taxes, businesses also benefit by not accumulating substantial unpaid payroll taxes and avoiding the associated penalties and interest. Over time, unpaid balances may compound beyond a business’s ability to pay and ultimately cause financial jeopardy.

### **Tracking Employer-PSP Relationships Would Allow the IRS to Intervene Before Victims Accumulate Substantial Payroll Tax Balances.**

In TY 2010, the IRS established a process to track and cross-reference employer-agent relationships for aggregate filers by creating Schedule R (Form 941), *Allocation Schedule for Aggregate Form 941 Filers*.<sup>25</sup> The Schedule R (Form 941) includes a list of all employers using the aggregate filer and the specific payroll liability, deposits, and payments for each employer reported by the agent on the aggregate Form 941.<sup>26</sup> Since 2007, the IRS has used transaction codes to cross-reference employers’ EINs with the aggregate filer’s EIN.<sup>27</sup>

However, the IRS is unable to link employer accounts to the EINs of PSPs because, unlike aggregate filers, PSPs file returns under the client employers’ EINs. Without tracking a PSP-client relationship, the IRS cannot accurately detect PSP failures affecting multiple employers and timely intervene to assist victims and protect tax revenues.

The adoption of the Preparer Tax Identification Number (PTIN) regulations provides the IRS with an opportunity to cross-reference PTINs of paid preparers of employment tax returns, including PSPs, with EINs of their clients.<sup>28</sup> Systemically linking the PTIN of a PSP with EINs of its clients will enable the IRS to:

- Track the number of employers associated with a PSP;

<sup>25</sup> Aggregate filers are also commonly referred to as “IRC § 3504 agents” or “Form 2678 agents.” These agents report, deposit, and pay employment taxes of their clients under the agent’s EIN. Both the section 3504 agent and the employer are liable for the employer’s employment taxes while the agent authorization is in effect. See IRC § 3504; Rev. Proc. 70-6, 1970-1 C.B. 420; Form 2678, *Employer/Payer Appointment of Agent*. See also Prop. Reg. § 31.3504-1(b), 75 Fed. Reg. 1735-01 (Jan. 13, 2010) (allowing aggregate filing of Forms 940 if the employer is a home care service recipient (HCSR); developed in collaboration with TAS); National Taxpayer Advocate 2007 Annual Report to Congress 355-373 (Most Serious Problem: *Employment Tax Treatment of Home Care Service Recipients*).

<sup>26</sup> IRM 5.1.24.4.4.1 (Aug. 15, 2012); 21.7.2.4.7.7 (Oct. 1, 2011). Similarly, the Schedule R (Form 940), designed for aggregate filers of the Form 940, includes a list of HCSRs as well as a breakdown of the payroll liability of each HCSR. IRM 21.7.3.4.7 (Jan. 24, 2011).

<sup>27</sup> When an IRC § 3504 agent is appointed, a Transaction Code (TC) 971, Action Codes 382, 383, 384, or 385, is input to the employer’s master file account to signify the appointment of a section 3504 agent. The TC 971 is displayed on the Integrated Data Retrieval System (IDRS) (Command Codes ENMOD and BMFOL“E”) and can be cross-referenced to the aggregate agent’s EIN. IRM 5.1.24.4.4(8) (Aug. 15, 2012).

<sup>28</sup> In September 2010, Treasury issued regulations requiring paid preparers of most tax forms to obtain a PTIN. Treas. Reg. § 1.6109-2. See also Treas. Reg. § 31.6109-2; Notice 2011-6, 2011-3 I.R.B. 315.

- Identify a PSP for a Revenue Officer review or investigation when a number of delinquent employment tax returns of the PSP's clients exceeds an established threshold;
- Generate “dual confirmation” notices to all employers associated with a PSP when the number of employers' addresses changed to that of the PSP exceed a certain threshold;<sup>29</sup> and
- Generate notices to warn all employers associated with a failed PSP about potential accumulation of unpaid employment tax liabilities on their accounts, thereby minimizing interest and penalties and improving their ability to remain in business.<sup>30</sup>

*Tracking Employer-PSP Relationships Would Allow the IRS to Take Timely Enforcement Actions Against Failed PSPs.*

The IRS should establish an early intervention program for tracking PSP-associated delinquencies and promptly stopping failed PSPs from accumulating large balances of unpaid employment tax liabilities on their clients' tax accounts.<sup>31</sup> Such actions may include:

- Reprogramming the Federal Tax Deposit (FTD) Alert program to generate a field case when the accumulated balance of all delinquent employer accounts associated with a PSP PTIN exceeds a certain threshold;<sup>32</sup>
- Promptly initiating TFRP investigations of PSPs and responsible persons within a PSP;<sup>33</sup>
- Reporting a failed PSP to the proper IRS oversight office, including the IRS Return Preparer Office, IRS Office of Professional Responsibility, or the Criminal Investigation Division; and
- Referring a delinquent PSP that continues to accumulate employment tax liabilities on client employer accounts to the U.S. Department of Justice for a court injunction to curtail the increasing delinquencies.<sup>34</sup>

<sup>29</sup> See IRS Office of Chief Counsel Memorandum, Ref. No. PRESP-116879-09, Use of Dual Confirmation Letters for Address Changes of Form 941 Filers Who Use Reporting Agents or Other Third Parties (Aug. 19, 2009). The dual confirmation notice is to be sent to the taxpayer's new and old address. The notice would suggest contacting the IRS only if the taxpayer has not initiated the change of address.

<sup>30</sup> A failed PSP is a provider that does not properly report or timely pay employment taxes on behalf of its client employers for any reason, including bankruptcy or embezzlement.

<sup>31</sup> It may take many months for the IRS to act even in routine employment tax delinquencies that are not complicated by fraud. National Taxpayer Advocate 2007 Annual Report to Congress 337-354 (Most Serious Problem: *Third Party Payers*).

<sup>32</sup> See generally IRM 5.7.1 (May 15, 2012); IRM 5.1.10 (Oct. 28, 2011); IRS Notice 931, *Deposit Requirements for Employment Taxes* (Oct. 2012). The IRS historically restricted the use of the FTD Alert program to larger employers (i.e., those that have reported more than \$50,000 in payroll taxes during the preceding four-quarter look-back period, which runs from July 1 through June 30 of the preceding calendar year).

<sup>33</sup> See IRM 5.7.3.3.3 (July 19, 2012). Consistent with a 2004 legislative recommendation by the National Taxpayer Advocate, the IRS has issued internal guidance stating that it can assess the TFRP against third-party payers. See SB/SE, *Interim Guidance for Conducting Trust Fund Recovery Penalty Investigations in Cases Involving a Third-Party Payer*, SBSE-05-0711-044 (July 1, 2011); National Taxpayer Advocate 2004 Annual Report to Congress 394-399.

<sup>34</sup> See, e.g., Circular 230, *Regulations Governing Practice before the Internal Revenue Service*; IRC § 7402(a).



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*Preventing Employers From Falling Victim to PSP Failures Could Improve Employment Tax Compliance and Alleviate Burden.*

In prior Annual Reports to Congress, the National Taxpayer Advocate recommended measures that could prevent or minimize the negative impact of PSP failures on employers.<sup>35</sup> The National Taxpayer Advocate commends the IRS for revising guidance for Reporting Agents (Form 8655 Agents) that make Federal Tax Deposits and Federal Tax Payments (FTPs) to the IRS on behalf of clients.<sup>36</sup> The new guidance requires agents to use the Treasury Department’s Electronic Federal Tax Payment System (EFTPS) or another electronic system (known as the Federal Tax Application (FTA)).<sup>37</sup> Reporting Agents also must remind their clients that the ultimate responsibility for paying taxes remains with the client and that the client should use the EFTPS system to periodically confirm that deposits have been made as expected.<sup>38</sup>

The IRS should expand to PSPs the requirement to remit tax deposits and payments to the Treasury electronically. Such a requirement will prevent unscrupulous PSPs from accumulating taxpayer funds intended for payment of payroll taxes by removing the opportunity for misappropriation, when the funds are transferred directly from the client’s bank account to the Treasury via EFTPS or FTA. The requirement to remit employment taxes via EFTPS would also permit PSP clients to verify the payment of employment taxes in real time.

As noted in a prior report, TAS recommends that the IRS develop a competency exam for preparers of employment tax returns that are not in an exempt category (*i.e.*, attorney, certified public accountant, or enrolled agent) with a vigorous ethics component.<sup>39</sup> A commitment by the IRS to develop additional examinations covering payroll tax topics would send a signal to preparers and PSPs alike that the IRS is focused on noncompliance in this area.

We commend the IRS for studying the EFTPS program in connection with third-party payers.<sup>40</sup> The study recommended specific changes that would allow EFTPS to automatically issue “inquiry” passwords (PINs) and to email confirmations of scheduled payments

<sup>35</sup> National Taxpayer Advocate 2009 Annual Report to Congress 261-262; National Taxpayer Advocate 2007 Annual Report to Congress 337-354 (Most Serious Problem: *Third Party Payers*).

<sup>36</sup> The National Taxpayer Advocate and payroll industry associations long advocated for and supported these changes. See, e.g., National Payroll Reporting Consortium and Independent Payroll Providers Association letter to the National Taxpayer Advocate (Feb. 5, 2008).

<sup>37</sup> See Rev. Proc. 2012-32, 2012-34 I.R.B. 267, *modifying and superseding* Rev. Proc. 2007-38, 2007-1 C.B. 1442, and Rev. Proc. 2012-33, 2012-34 I.R.B. 272, *modifying and superseding* Rev. Proc. 98-32, 1998-1 C.B. 935. The guidance is effective Nov. 19, 2012. A transfer of funds to the Treasury via EFTPS can occur from a taxpayer’s bank account or from a master account maintained by the third-party provider. EFTPS Batch Provider Software User Manual 20 (June 2011).

<sup>38</sup> This disclosure statement has long been a best practice among National Payroll Reporting Consortium members. See NPRC, Government Corner, *available at* <http://www.nprc-inc.org/govc.html> (last visited Sept. 9, 2012).

<sup>39</sup> National Taxpayer Advocate 2011 Annual Report to Congress 429-431.

<sup>40</sup> SB/SE Research Study: *EFTPS Program, Requirements Change Notice for EFTPS – Final Report*, Executive Summary and Recommendations (Apr. 24, 2012).

to employers enrolled in the EFTPS by a third-party provider (payer).<sup>41</sup> These changes, if implemented by the Financial Management Service, will provide employers with efficient tools to monitor the actions of their PSPs or other third-party payers, verify that their employment tax obligations are timely met, and take timely actions against unscrupulous PSPs.<sup>42</sup>

The National Taxpayer Advocate reiterates that the IRS should promptly issue dual address change notices to alert employers when a PSP has initiated a change of address.<sup>43</sup> Although SB/SE and TAS created a team in 2009 to address this recommendation, the IRS has been slow to implement this change, citing cost concerns.<sup>44</sup> We encourage the IRS to modify the program to generate dual change of address notices, by email or text messages, after obtaining permission from taxpayers.<sup>45</sup> To avoid potential disclosure violations, the IRS could create a special field on employment tax returns to request express permission from taxpayers to notify them via email and text.<sup>46</sup> This approach would save funds and improve the efficiency and speed of notification.

**Ambiguous Procedures and Inadequate Training Materials Limit the Use of ETA OICs as a Viable Collection Alternative in Providing Relief to Victims of PSP Failures.**

When a PSP goes out of business or embezzles client employer funds, the employer remains ultimately responsible for unpaid tax, interest, and penalties.<sup>47</sup> From a taxpayer's perspective, he or she must pay the tax twice.<sup>48</sup>

Congress granted the IRS the authority to compromise a tax debt on the basis of hardship, public policy, and equity, by using an ETA OIC.<sup>49</sup> While a single PSP failure can result in millions in unpaid employment taxes and thousands of victimized employers, the IRS has underutilized the ETA offer authority.<sup>50</sup> As Figure 1.23.1 below shows, the number of accepted NEH-ETA OICs ranged between 21 and 45 during the past five years, with only 28

<sup>41</sup> EFTPS Requirements Change Notice (May 1, 2012). See also Email Confirmation of EFTPS Payments for Clients of Third-Party Payers, Executive Briefing (Apr. 24, 2012).

<sup>42</sup> EFTPS is managed by Treasury's Financial Management Service (FMS) bureau. See <http://www.fms.treas.gov>.

<sup>43</sup> The notice is to be sent to the taxpayer's new and old address. The notice would suggest contacting the IRS only if the taxpayer has not initiated the change of address. This recommendation is consistent with best practices in U.S. banking industry.

<sup>44</sup> The team currently evaluates options, preferring the one that contemplates that the address cannot be changed by filing a quarterly employment tax return. The taxpayer would have to either file the IRS Form 8822, *Change of Address* (or similar correspondence), or an annual income tax return (such as IRS Forms 1040, 1065, or 1120 series) showing a new address. In these cases, the IRS will follow up with dual confirmation notices.

<sup>45</sup> E.g., using both encrypted and unencrypted emails and text messages is a standard business practice in the banking industry. See generally IRC § 6103.

<sup>46</sup> See *id.*

<sup>47</sup> The IRS automatically assesses the Failure to File, Failure to Pay, and Failure to Deposit penalties against delinquent businesses under IRC §§ 6651(a)(1), (a)(2), and 6656, respectively. The IRS also may pursue the TFRP against the individuals it determines to be responsible who have willfully failed to pay the trust fund portion of the delinquent taxes, under IRC § 6672. Trust fund taxes represent the income tax, Social Security, and Medicare taxes employers withhold from their employees' wages.

<sup>48</sup> National Taxpayer Advocate 2007 Annual Report to Congress 344-345, 350.

<sup>49</sup> IRC § 7122(c); IRS Restructuring and Reform Act of 1998 (RRA 98), Pub. L., No. 105-206 (1998) (RRA 98). See also Treas. Reg. § 301.7122-1.

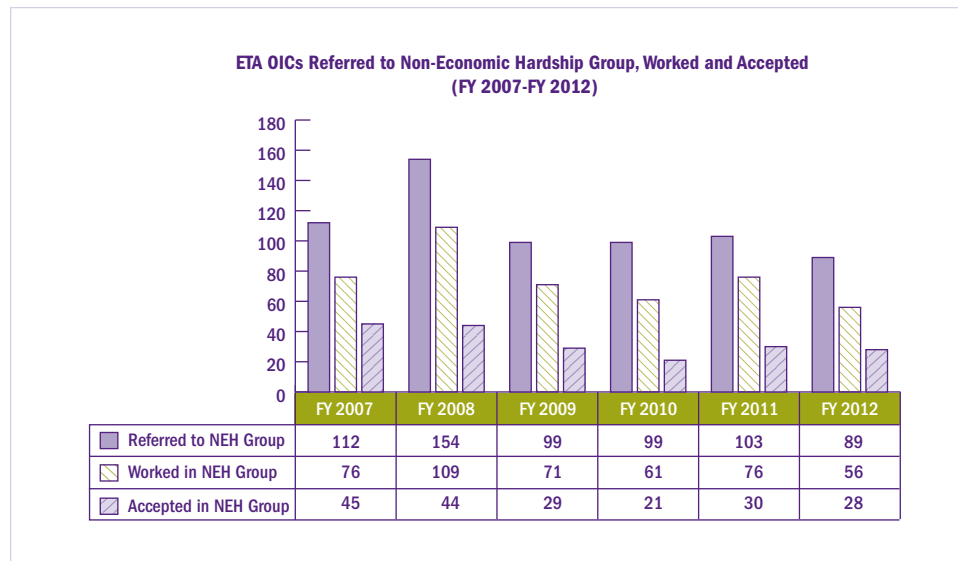
<sup>50</sup> Between FY 2007 and FY 2012 (to date), as a result of the IRS's recommendations, the DOJ criminally prosecuted at least 24 owners and operators of different types of third-party payers who collected about \$300 million in employment taxes from their client employers and did not pay them over to the Treasury. IRS, Employment Tax Fraud, Case Examples, FY 2007 - FY 2012,



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offers accepted during the last full fiscal year (2012), a nearly 38 percent decrease from the 45 accepted in FY 2007.<sup>51</sup>

**FIGURE 1.23.2, ETA OICs Referred to Non-Economic Hardship Group, Worked, and Accepted in Fys 2007-2012<sup>52</sup>**



Acting on the National Taxpayer Advocate’s recommendation, the IRS conducted a study that recommended creating a separate IRM section devoted to third-party payer issues.<sup>53</sup> The study also recommended considering ETA OICs as viable collection alternatives for taxpayers who have been harmed by third-party payers.<sup>54</sup> While these recommendations were adopted in the new IRM, *Third Party Payer Arrangements for Employment Taxes*, it refers the reader to pre-existing provisions in the IRM for effective tax administration offers, which contain contradictory statements.<sup>55</sup> For example, IRM 5.8.11.2.2.1(4) states (in an amplifying note), “The Service will not compromise on public policy or equity grounds solely on the argument that the acts of a third party caused the unpaid tax liability (including representatives, partners, agents, or employees).” This note conflicts with the PSP example immediately preceding it, which states:

<sup>51</sup> See IRS responses to TAS information requests (June 29 and Oct. 22, 2012).

<sup>52</sup> OICs based on considerations of equity and public policy are commonly referred to as non-economic hardship ETA offers, and they are worked in a centralized offer group (NEH-ETA) located in Austin, Texas. See IRM 5.8.11.2.2 (Sept. 23, 2008). Actual decline is 37.8 percent.

<sup>53</sup> SB/SE Study, Program Review of Third Party Payers (undated); IRS response to TAS information request (Aug. 26, 2012). See also IRM 5.1.24, *Third Party Payer Arrangements for Employment Taxes* (Aug. 15, 2012). See also National Taxpayer Advocate 2007 Annual Report to Congress 337-354 (Most Serious Problem: *Third Party Payers*).

<sup>54</sup> Because the IRS defines economic hardship as the inability to meet reasonable basic living expenses, it only applies to individuals (including sole proprietorships). Business entities may apply only for Non-Economic Hardship ETA OICs (i.e., based on public policy or equity grounds). IRM 5.8.11.2.1 (Sept. 23, 2008); IRM 5.8.11.2.2.1 (Sept. 23, 2008). See also National Taxpayer Advocate 2011 Annual Report to Congress 537-543 (Legislative Recommendation: *Amend IRC § 6343(a) to Permit the IRS to Release Levies on Business Taxpayers That Impose Economic Hardship*).

<sup>55</sup> IRM 5.1.24.5.7 (Aug. 15, 2012); IRM 5.8.11.1.2.2.1 (Sept. 23, 2008).

The taxpayer was using a payroll service provider (PSP) who deducted all tax payments from the taxpayer's bank account, yet did not remit them to the Service. The taxpayer took all reasonable precautions to prevent this from occurring. The PSP falsified documents to conceal the embezzlement. Since the abatement of interest is not available under 6404(e) on employment taxes, an offer in the amount of the tax balance may be accepted. The taxpayer's overall compliance history does not weigh against acceptance of the offer.<sup>56</sup>

IRS employees may be confused by these statements, and therefore use the non-economic hardship ETA OICs sporadically, harming the innocent victims of PSP misappropriation. The IRM, given the express refusal to allow an ETA OIC in a failed PSP situation, does not suggest that the IRS is willing to work with victims of embezzlement or intends to make it easier for them to enter into an OIC under the principles set forth in RRA 98.<sup>57</sup> The IRM example shows that current IRS's approach to PSP failures undermines and restricts the IRS's ETA OIC authority based on equity and public policy considerations.

The IRS's FY 2012 Revenue Officer training on third-party payer arrangements provides only scant mention of ETA OICs in the context of PSP embezzlement or bankruptcy, and directs readers to the associated confusing and ambiguous section of the IRM for information.<sup>58</sup> It does not even remotely imply that the IRS might be willing to compromise the tax and associated penalties and interest in considering an ETA offer in compromise.

The National Taxpayer Advocate remains concerned that the IRS has yet to acknowledge, in both its IRM provisions and in RO training, that, from a taxpayer's point of view, the law requires a victim of a PSP failure or embezzlement to pay the tax twice, with interest and penalties. The IRS believes it should not favor one business over another by compromising the tax liability itself, thereby giving a competitive advantage to the victim of a PSP failure over an employer that paid its taxes to the IRS. This approach ignores the fact that the victim has experienced the same economic impact of paying the amount of tax to the PSP as the competitor business that paid it to the IRS.

Victims of PSP failures are employers who tried to (and to their mind, did) comply with the tax laws. The IRS's failure to acknowledge this reality demonstrates a lack of concern for the victim's economic harm and increases the risk of future noncompliance and business failure. While commending the IRS for conducting a study on third-party payers and

<sup>56</sup> IRM 5.8.11.2.2.1(4), Example (Sept. 23, 2008).

<sup>57</sup> RRA 98, Pub. L. No. 105-206 (1998). The legislative history shows that Congress intended "that the IRS should make it easier for taxpayers to enter into offer-in-compromise agreements, and should do more to educate the taxpaying public about the availability of such agreements." S. Rep. 105-174, at 94, 105th Cong., 2nd Sess. (1998), Congress also expanded the IRS's OIC authority to permit considering additional factors besides the doubt as to liability or collectability. Congress anticipated "that the IRS will take into account factors such as equity, hardship, and public policy," believed "that the ability to compromise tax liability ...enhances taxpayer compliance," and expected the IRS to "be flexible in finding ways to work with taxpayers who are sincerely trying to meet their obligations and remain in the tax system." H.R. Conf. Rep. 105-599, at 289, 105th Cong., 2nd Sess. (1998).

<sup>58</sup> SB/SE CPE Training Module (FY 2012), *Third Party Payer Arrangements for Employment Taxes*; IRS response to TAS information request, Item 2 15 (July 26 2012). See also IRM 5.8.11.2.2.1 (4) (Sept. 23, 2008).

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implementing the new IRM section, we recommend that the IRS revise the ETA OIC IRM provisions to make them consistent with the new IRM section on third-party payers and also explicitly acknowledge that the amount of tax itself may be compromised in appropriate situations. The IRS needs to educate both its own revenue officers and taxpayers about the availability of the non-economic hardship ETA OICs in PSP misappropriation situations.

### **Targeted Communications and a Focused Outreach Strategy Can Provide Necessary Information to Employers About the Risks Inherent in Outsourcing Payroll and How to Protect Themselves.**

We agree with the IRS that employers should use due diligence in choosing a PSP.<sup>59</sup> However, as a tax administration agency, the IRS has an obligation to educate taxpayers about their tax responsibilities and facilitate prudent compliance. In recent years, the IRS has substantially improved the information about PSPs and other TPPs on its website.<sup>60</sup> However, it needs a more comprehensive, targeted communications and outreach strategy to inform small businesses and self-employed individuals about the different third party arrangements for payment of employment taxes and how to protect against risks inherent in outsourcing payroll tax obligations. Such a strategy should include seminars and presentations in local communities to address compliance and cultural issues in those communities.<sup>61</sup>

We recommend that IRS use innovative and cost effective ways of educating employers about TPPs, including email and text messages, webcasts, online chats, and smartphone applications. The IRS also should modify its employment tax forms and publications to discuss the risks associated with outsourcing payroll, and use correspondence, including notices and “soft letters” as an opportunity to educate taxpayers about EFTPS.<sup>62</sup>

## **CONCLUSION**

The National Taxpayer Advocate is pleased that the IRS has made significant progress in addressing problems with PSPs and other third party payers identified in prior Annual Reports to Congress. We also commend the IRS for the fruitful collaboration with TAS on these issues.

<sup>59</sup> National Taxpayer Advocate 2007 Annual Report to Congress 344.

<sup>60</sup> See Third Party Payer Arrangements, <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Outsourcing-Payroll-and-Third-Party-Payers>. (last visited Sept. 11, 2012). See also Employment Tax Fraud, Case Examples, FY 2010 – FY 2012, <http://www.irs.gov/uac/Examples-of-Employment-Tax-Fraud-Investigations---Fiscal-Year-2012> (last visited Sept. 11, 2012).

<sup>61</sup> In FY 2011, SB/SE targeted less than a quarter of outreach events directly to small business owners and lacked outreach and education employees in 12 states. See Most Serious Problem: *The IRS Is Substantially Reducing Both the Amount and Scope of its Direct Education and Outreach to Taxpayer and Does not Measure the Effectiveness of its Remaining Outreach Activities, Thereby Risking Increased Noncompliance*, *infra/supra*.

<sup>62</sup> The National Taxpayer Advocate applauds the IRS for its recent efforts to reassess the benefits of using “Soft Letters” with a broader range of taxpayers. IRS response to TAS information request (July 26, 2012), Item 5: FTD Soft Letter Project (July 2011).

However, the National Taxpayer Advocate is concerned that the IRS is slow in implementing necessary measures and investing necessary resources in early detection and timely intervention in PSP delinquencies. As a result, absent effective collection alternatives, many victims of PSP misappropriation may face grave financial harm and be forced to close doors and lay off employees. The IRS can and should do more to alleviate harm to taxpayers affected by PSP failures.

The National Taxpayer Advocate preliminarily recommends that the IRS:

1. Develop programming that can systemically link the PTIN of a PSP with EINs of its clients and track the number of employers associated with the PSP.
2. Develop programming that can systemically select a PSP for a Revenue Officer examination when the number of delinquent employment tax returns of clients of a PSP exceeds an established threshold.
3. Establish an early intervention program for tracking PSP-associated delinquencies and taking prompt actions to stop failed PSPs from continuing to accumulate large balances of unpaid employment taxes on their clients' tax accounts.
4. Require PSPs (who are not Reporting Agents) to remit federal tax deposits and payments to the Treasury via EFTPS or FTA.
5. Consistent with the SB/SE study recommendations, request the FMS to program EFTPS to automatically issue "inquiry" passwords (PINs) and to email confirmations of scheduled payments to employers enrolled in the EFTPS by a third-party provider (payer).
6. Develop a competency exam for preparers of employment tax returns with a vigorous ethics component.
7. Begin using dual address change letters alerting employers that a PSP has initiated a change of address, including notifications via email or text messages to taxpayers who so consent in a special field on employment tax returns.
8. Promote the use of ETA OICs as a viable collection alternative for victims of failed PSPs by revising the IRM to specifically state that the amount of tax may be compromised in appropriate instances and by developing adequate training materials for employees.
9. As part of a comprehensive outreach strategy, alert employers about the risks inherent to outsourcing payroll in employment tax forms and publications, IRS Notices, and other correspondence.

## IRS COMMENTS

The IRS acknowledges that some small businesses can be adversely impacted when the third party they hired to handle its employment tax responsibilities fails to fulfill its obligations. While the IRS does play an important role in assisting employers that fall victim to fraudulent PSPs, under the law, the employer is not relieved from its employment tax obligations when entrusting intermediaries with the deposit and payment of their federal tax liabilities. The IRS strongly and consistently encourages employers using third-party payroll providers to use due diligence in the selection of a third-party payer with regard to the compliance associated with their tax obligations.

To that end, the IRS is working hard to educate employers on the risks associated with outsourcing payroll and how to protect themselves. We maintain a webpage, “Outsourcing Payroll Duties,” on IRS.gov.<sup>63</sup> This webpage encourages employers using third-party payroll providers to verify and confirm timely deposits made on their behalf by utilizing the EFTPS. The webpage also guides employers on how to respond if they believe that a bill or notice received is a result of a problem with their payroll service provider. In addition, the IRS routinely focuses outreach efforts on employers who outsource their payroll with a variety of communications, including a special edition of Tax Tips, articles in e-News for Small Businesses and the SSA/IRS Reporter, a video on IRS.gov, and an outreach initiative.<sup>64</sup>

While educating employers on understanding the need for due diligence in selecting a third-party payer and exercising appropriate oversight of PSP deposit practices is essential, the IRS also acknowledges the benefits of early intervention and its importance in the prevention of pyramiding employment tax liabilities. Specifically, the IRS utilizes the FTD Alert process, which helps to identify, at an early stage, a depositor who has not made federal tax deposits during the current quarter, or who has made deposits in substantially lower amounts from prior quarters. When appropriate, the FTD Alert program generates an alert in the name of a PSP client taxpayer and triggers a Revenue Officer to contact the business within ten days. Typically, this contact occurs prior to the due date of the current employment tax return and can be successful in detecting when the PSP is not making timely deposits. Additionally, the IRS is also engaged in a collaborative effort with Financial Management Service and the payroll industry to develop enhancements to EFTPS which will provide additional opportunities for employers to verify and confirm timely deposits made by a third party.

<sup>63</sup> See Outsourcing Payroll Duties available at <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Outsourcing-Payroll-Duties> (last visited on Nov. 8, 2012).

<sup>64</sup> See, e.g., Special Edition Tax Tip 2011-05, Sept. 2, 2011 available at <http://www.irs.gov/uac/Three-Tips-for-Employers-Outsourcing-Their-Payroll>; Outsourcing Payroll Duties article in e-News for Small Businesses (Issue 2011-17, Aug. 3, 2011); IRS video Outsourcing Payroll available at <http://www.irsvideos.gov/SmallBusinessTaxpayer/Employers/OutsourcingPayroll2011>; and SB/SE Outreach Initiative available at [http://sbse.web.irs.gov/CL2/SL/outreach\\_initiatives/rq\\_view.asp?id=274](http://sbse.web.irs.gov/CL2/SL/outreach_initiatives/rq_view.asp?id=274).

The IRS appreciates the National Taxpayer Advocate's acknowledgement of the significant progress we have made to address PSP and other third-party payer failures. During FY 2012, we created and published IRM section 5.1.24, *Third-Party Payer Arrangements for Employment Taxes*. This new IRM section provides comprehensive guidance for Collection employees on the various types of third-party payer arrangements for employment taxes that exist, explains how these third-party payer arrangements may affect collection and helps to ensure fair and consistent treatment. Guidance for the assessment of the Trust Fund Recovery Penalty also was updated to include consideration of potentially responsible parties within a PSP or a professional employer organization. The new guidance and procedures were effectively reinforced through comprehensive training to all field contact employees during 2012.

In further demonstration of our efforts to ensure consistent and fair treatment of taxpayers adversely impacted by deceptive third-party payers, a new Letter 4838, *Payroll Service Provider Client*, was made available to Collection employees for use in contacting clients of a non-compliant PSP. This letter encourages those PSP clients to contact the IRS to resolve any outstanding liabilities and addresses the potential for penalty abatement. Additionally, the Reasonable Cause Assistant (RCA) program has been modified to include additional questions to better identify employers adversely affected by their third-party payer and grant the employers penalty relief. Additional questions have also been added to Form 4180, *Report of Interview with Individual Relative to Trust Fund Recovery Penalty or Personal Liability for Excise Taxes*, to aid revenue officers in TFRP investigations where a PSP or a PEO is involved. The additional information helps to ensure field employees have sufficient facts and information to make informed decisions on how best to resolve these cases.

And finally, the IRS agrees that the Effective Tax Administration offer in compromise is a viable collection alternative for those taxpayers that meet the established ETA criteria. To that end, upon initial contact with an employer whose liability was affected by the actions of a third-party payer, revenue officers are instructed to discuss an ETA OIC as part of the collection determination.<sup>65</sup>

The National Taxpayer Advocate makes nine preliminary recommendations to help victims of failed payroll service providers and increase employment tax compliance. The IRS is taking or has taken the following actions with respect to these recommendations:

The IRS agrees that tracking the number of employers associated with a PSP has value. While linking the PTIN of a PSP with the EINs of its clients is one option to use for tracking a PSP — client relationship, it may not be feasible due to the extensive programming costs and the relatively small number of impacted accounts. As such, we will continue to analyze various options for establishing a systemic linkage between a PSP and its clients that does not create additional taxpayer burden through additional reporting requirements.

<sup>65</sup> See IRM 5.1.24.5.2(2)(e) (Aug. 15, 2012).



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Until the successful implementation of a systemic linkage between a PSP and its clients, as discussed above, programming cannot be created to systemically select a PSP for revenue officer (RO) examination when the number of delinquent client employment tax returns exceeds a set threshold.

We agree with the benefits of an early intervention program to identify PSP-associated delinquencies and efforts to take prompt actions on these accounts. Accordingly, as part of a pilot operation, the IRS is actively testing and studying the use of Letter 4594, FTD Soft Letter, to improve the FTD Alert early intervention program and increase the ability for PSP client identification. This “soft letter notice” is used to contact business taxpayers in which account indicators are present that a potential tax liability will exist for the business due to reduced FTDs. The soft letter notice explains the importance of making federal tax deposits timely and the consequences if not made timely. The letter also reminds the taxpayer to file the Form 941 timely to prevent additional penalties and provides IRS contact information if assistance is needed. While the results of the pilot are being evaluated, preliminary information indicates this effort has been effective in reacting faster and earlier to indicators that a business may be in trouble and by providing education to taxpayers before a significant liability occurs. Metrics have been developed to assist the IRS in determining the overall impact the soft letter notice will have on future compliance. We believe this overall approach will assist in making data driven decisions to improve the FTD Alert early intervention program and increase the ability for PSP clients to be identified.

To provide further early intervention opportunities for clients of PSPs, the IRS has proposed implementation of additional tools within the EFTPS, which will allow the taxpayer to timely monitor federal tax payments being made on their behalf.

The IRS agrees with requiring PSPs (who are not Reporting Agents) to remit federal tax deposits via EFTPS. Consistent with this recommendation, the U.S. Department of Treasury executed Treasury Decision (T.D.) 9507.<sup>66</sup> T.D. 9507 provides rules under which all depositors, including PSPs, must use electronic funds transfer (EFT) for all FTDs and eliminates the rules regarding FTD coupons. These regulations became effective January 1, 2011.

In May 2012, FMS approved our request for the automatic issuance of inquiry PINs for clients of PSPs and other third-party providers (payers) and email confirmations of scheduled payments from EFTPS.<sup>67</sup> We are actively working with FMS and the payroll industry on methods to implement these enhancements to the system.

As acknowledged by the National Taxpayer Advocate in the 2011 Annual Report to Congress,<sup>68</sup> establishing a testing program is an extensive undertaking. Due to the size and vulnerability of the individual taxpayer population, the IRS focused initially on one return

<sup>66</sup> See T.D. 9507, 2011-3 I.R.B. 305.

<sup>67</sup> See Requirements Change Notice 293 for Inquiry PINs and Email (May 11, 2012).

<sup>68</sup> National Taxpayer Advocate 2011 Annual Report to Congress 427-430.

preparer examination, starting with the Form 1040 series returns. Prior to proceeding with the development of any additional examinations, the IRS needs to assess the impact of the Registered Tax Return Preparer test and review the costs and benefits of the test. Over the next several years, we will be reviewing various metrics that measure the success of the program.

The IRS is continuing its efforts to complete implementation actions associated with a prior National Taxpayer Advocate Annual Report to Congress recommendation regarding issuance of dual address change letters.<sup>69</sup> Consistent with this effort, the IRS has researched the feasibility of implementing change of address notices to all business taxpayers that use a PSP. Following a thorough analysis of several options, specific recommendations for the implementation of a dual address change process are now being considered by IRS Counsel. The recommendations now being considered include:

- Establishment of an official mailing address for the company. This address will be the address on the income tax return.
- No change of address will be made unless the taxpayer files Form 8822-B, *Change of Address – Business*, or other correspondence from the taxpayer, which will then be followed up with a confirmation letter to the taxpayer at the old and new addresses.

The IRS will continue to pursue the successful and cost effective implementation of this recommendation. The IRS would need additional time to consider notification of address changes via email or text message as security and disclosure concerns must be considered.

To promote the use of ETA OICs as a viable collection alternative for victims of failed PSPs, the IRS has revised the IRM to specifically state that the amount of tax may be compromised in appropriate instances. We also developed training materials for employees. Other planned actions include:

- Conducting training in the recognition of ETA economic hardship and non-economic hardship situations with all offer examiners and offer specialists who investigate OICs during the first quarter of FY 2013.
- Developing an ETA and Non-economic Hardship (NEH) ETA training course for field revenue officers for inclusion in CPE for FY 2013.
- Completing a revision to IRM 5.8.11, *Effective Tax Administration*, during FY 2013, which will include additional examples of situations where acceptance of an offer under public policy or equity may be appropriate, and note that the amount of tax may be compromised when appropriate.

The IRS agrees that it is important to educate employers on the risks associated with outsourcing payroll duties via employment tax forms and publications, IRS notices, and other correspondence. We recently proposed adding language to the instructions for the

<sup>69</sup> National Taxpayer Advocate 2010 Annual Report to Congress 179.

94X series of employment tax returns and to the Publication 15, (*Circular E*), *Employer's Tax Guide*, to caution employers about changing their mailing address to that of their PSP and provide alternative methods for payroll providers to receive copies of IRS notices. Employers will also be alerted to their responsibility for employment taxes in the new EFTPS inquiry PIN letters and email confirmations of scheduled payments. The IRS will continue to examine its products and services for additional opportunities to provide employers with information on outsourcing payroll.

In conclusion, the IRS is committed to improving its policies and procedures with PSPs and other third-party payers who are entrusted by employers to file and pay on their behalf. While the ultimate responsibility remains with the employer to use due diligence in handling employment tax obligations, the IRS will continue its efforts to focus on educating taxpayers, developing early intervention tools, and encouraging the use of the ETA OIC as a viable collection alternative in hopes of decreasing and/or minimizing the burden and financial impact to the taxpayer.

### Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS recognizes the burdens facing small businesses that are adversely affected by PSP failures. We also commend the IRS for its significant progress in improving outreach to employers about the risks associated with outsourcing payroll and how to protect themselves. The National Taxpayer Advocate is pleased with the requirement to remit all federal deposits, including those made by PSPs on behalf of their clients, using EFTPS. We are encouraged by the FMS's approval of the automatic issuance of inquiry PINs for clients of PSPs and other third-party providers (payers) and email confirmations of scheduled payments from EFTPS. These changes will improve service to affected employers and minimize the risks associated with using a PSP. We hope that the IRS will promptly implement these enhancements to the system and use modern technology (*e.g.*, email alerts and text messages) to educate employers about risks associated with outsourcing payroll.

However, the IRS can and should do more to alleviate the harm to victims of PSP failures. The IRS cannot limit its role to education and outreach, relying on the employer's ultimate responsibility for payment of employment taxes. Instead, the IRS should take an active role in the prevention of PSP delinquencies and the resolution of PSP-related liabilities. As stated above, each PSP failure can affect thousands of employers and millions of dollars in unpaid payroll taxes. Because the victims of defunct PSPs will have to pay the amount of tax twice — once to the PSP, and again to the IRS — some will go out of business, leaving their employees without jobs and often leaving the IRS with scarce assets from which to collect.

The National Taxpayer Advocate remains concerned about the IRS's unwillingness to commit resources to the tracking of the employer-PSP relationship and early intervention in PSP cases. As the IRS acknowledges, without a systemic linkage between a PSP and its clients, it cannot design an effective early intervention program to identify PSP-associated delinquencies and take prompt actions on these accounts. The National Taxpayer Advocate is disappointed with the IRS's assumption that implementation of such a linkage "may not be feasible due to the extensive programming costs and the relatively small number of impacted accounts." The IRS should estimate the programming costs for cross-referencing employers' accounts with the PSP account using PTINs and pilot the systemic linkage to estimate the number of affected employers. It can then estimate the amount of revenue at risk if the identified PSPs go out of business and a Revenue Officer does not take prompt action. The National Taxpayer Advocate believes that the IRS should use a data-driven approach in determining feasibility of systemic linkage between PSPs and their client accounts.

While appreciative of the IRS's efforts to improve the FTD Alert early intervention program and increase the ability for PSP client identification using Letter 4594, FTD Soft Letter, the National Taxpayer Advocate believes that an effective early intervention program will not occur without the systemic linkage described above, especially in cases where a delinquent PSP changes addresses of client employers. It has been almost five years since the National Taxpayer Advocate recommended the use of dual confirmation letters when a PSP changes a client employer's address without a proper authorization.<sup>70</sup> Even though the IRS and TAS have collaborated on a number of options, none have been implemented so far. The National Taxpayer Advocate believes the IRS should establish timeframes for implementation of these address change notifications, including email and text message options.

The National Taxpayer Advocate believes that the importance of maintaining high standards of competence and due diligence among preparers of employment tax returns outweighs any cost-related concerns. A competency examination for PSPs and other employment tax return preparers will undoubtedly improve compliance and reemphasize the IRS's focus on noncompliance in this area. The IRS should establish timeframes for developing a competency examination and its implementation.

Finally, the National Taxpayer Advocate appreciates the IRS's acknowledgement of ETA OICs as a viable collection alternative for victims of defunct PSPs and the IRS's commitment to revise the relevant IRM and develop training materials for Revenue Officers. The IRS should publicize that the amount of tax itself may be compromised in appropriate situations. The National Taxpayer Advocate believes TAS should be afforded an opportunity to review this upcoming IRM revision and training materials.

<sup>70</sup> National Taxpayer Advocate 2007 Annual Report to Congress 337-354.

## Recommendations

In conclusion, the National Taxpayer Advocate recommends that the IRS:

1. Develop the business case for programming that can systemically link the PTIN of a PSP with EINs of its clients, track the number of employers associated with the PSP, and implement a pilot program to estimate the number of affected employers and impact to the public fisc.
2. Develop programming that can systemically select a PSP for a Revenue Officer examination when the number of delinquent employment tax returns of clients of a PSP exceeds an established threshold.
3. Develop a competency exam for preparers of employment tax returns with a vigorous ethics component.
4. Establish ascertainable timeframes for beginning the use of dual address change letters alerting employers that a PSP has initiated a change of address, including email or text message notifications to taxpayers who so consent in a special field on employment tax returns.
5. In consultation with TAS, revise the IRM and training materials to promote the use of ETA OICs as a viable collection alternative for victims of failed PSPs, including compromising the amount of tax in appropriate instances.
6. As a part of a comprehensive outreach strategy, use modern technology, such as text messaging and email alerts to educate employers about the risks inherent to outsourcing payroll.